

Western New England Law Review

Volume 12 12 (1990)
Issue 1

Article 2

1-1-1990

TAX LAW—AVAILABILITY OF THE INVESTMENT TAX CREDIT TO NONCORPORATE LESSORS UNDER THE SHORT-TERM LEASE TEST OF I.R.C. SECTION 46(e)(3)(B) AFTER MCNAMARA v. COMMISSIONER AND CONNOR v. COMMISSIONER

Gail M. Corbett

Follow this and additional works at: <http://digitalcommons.law.wne.edu/lawreview>

Recommended Citation

Gail M. Corbett, *TAX LAW—AVAILABILITY OF THE INVESTMENT TAX CREDIT TO NONCORPORATE LESSORS UNDER THE SHORT-TERM LEASE TEST OF I.R.C. SECTION 46(e)(3)(B) AFTER MCNAMARA v. COMMISSIONER AND CONNOR v. COMMISSIONER*, 12 W. New Eng. L. Rev. 75 (1990), <http://digitalcommons.law.wne.edu/lawreview/vol12/iss1/2>

This Comment is brought to you for free and open access by the Law Review & Student Publications at Digital Commons @ Western New England University School of Law. It has been accepted for inclusion in Western New England Law Review by an authorized administrator of Digital Commons @ Western New England University School of Law. For more information, please contact pnewcombe@law.wne.edu.

COMMENT

TAX LAW—AVAILABILITY OF THE INVESTMENT TAX CREDIT TO NONCORPORATE LESSORS UNDER THE SHORT-TERM LEASE TEST OF I.R.C. § 46(e)(3)(B) AFTER *McNamara v. Commissioner* and *Connor v. Commissioner*

INTRODUCTION

The Investment Tax Credit (ITC) is a credit against tax liability which Congress allows to businesses as an incentive for their purchase of qualified property (Section 38 property).¹ President Kennedy proposed the ITC in 1961 as a measure designed to stimulate the national economy. In response, Congress enacted the ITC the following year and since that time has reacted to swings in the economy by repeal or reenactment of the ITC.² In theory, the ITC is an incentive to promote business investment in machinery and equipment. Such investment results in modernization and expansion of plant and equipment which is linked to increased employment and higher per capita income.³ Thus, to stimulate the national economy effectively as intended by President Kennedy and the Congress, it is necessary that the credit be applied to actual investments in business property.⁴

Lessors are generally allowed to take an ITC for Section 38 property⁵ purchased for lease in their businesses. In 1971, however, Congress enacted I.R.C. Section 46(e)(3) which specifically restricts the

1. I.R.C. § 38 (1988) creates the Investment Tax Credit (ITC), and I.R.C. §§ 46-49 (1988) govern the mechanics of its application. *See infra* notes 23-27 and accompanying text. *See infra* note 5 presenting the text of I.R.C. § 38 (1988).

2. *See infra* note 20 and accompanying text for a discussion of the history of legislative repeal and reinstatement of the ITC. Congress has also reacted to swings in the economy by changing the amount of the allowable ITC. *See infra* note 21 and accompanying text.

3. *See infra* notes 19-22 and accompanying text for a discussion of the economic effects of the ITC.

4. *See infra* note 33 and accompanying text.

5. In pertinent part, I.R.C. § 38 (1988) provides for a "General Business Credit" as follows:

(a) Allowance of credit.—There shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the sum of—

ability of non-corporate lessors of Section 38 property to qualify for the ITC.⁶ Enactment of Section 46(e)(3) addressed congressional concern that partnerships or other non-corporate investors could use the ITC to shelter from tax income that is unrelated to the investment. Ideally, the ITC exceeds the tax liability derived from the partnership. The taxpayer is then able to apply the excess ITC against the tax liability that is incurred on income from other sources.⁷ Congress perceived shelter of unrelated income as undesirable because it subverts the goal of the ITC which is to encourage genuine investment in business property to stimulate the economy. This shelter is a tax loop hole that Congress closed by enacting Sections 46(e)(3)(A) and (B) to establish criteria for ITC eligibility by non-corporate lessors.

To qualify for an ITC, a lessor-taxpayer must meet the restrictions of either part (A) or part (B). Part (A) provides that the lessor either manufacture or produce the leased property.⁸ Part (B) provides

-
- (1) the business credit carryforwards carried to such taxable year,
 - (2) the amount of the current business year credit, plus
 - (3) the business credit carrybacks carried to such taxable year.

(b) Current year business credit.—For purposes of this subpart, the amount of the current year business credit is the sum of the following credits determined for the taxable year:

- (1) the investment credit determined under section 46(a),
- (2) the targeted jobs credit . . . ,
- (3) the alcohol fuels credit . . . ,
- (4) the research credit . . . , plus
- (5) the low-income housing credit

Id.

6. See *infra* note 29 for the full text of the statute. In pertinent part, I.R.C. § 46(e)(3) provides that the ITC is denied unless:

- (A) the lessor manufactured or produced the leased property or
- (B) [1] the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property, and

[2] for . . . the first 12 months after the date on which the property is transferred to the lessee the sum of the [allowable] deductions with respect to such property . . . exceeds 15 percent of the rental income produced by such property [15 percent test].

I.R.C. § 46(e)(3) (1988).

7. The partnership form of ownership avoids double taxation that applies to the corporate form of ownership. Partnership income is earned by the partnership and passes directly to the partners subject only to tax as their personal earnings or income. R. CLARK, CORPORATE LAW 15-16 n.39 (1986). Thus, the ITC flows directly through to the partner as a credit to his personal income. "[T]he federal income tax is assessed against the profits of the individual partners. There is no separate partnership income tax, although there is a separate corporation income tax." *Id.*

Under the corporate form of ownership, the entity is taxed on the income that it produces. That income is then taxed once again when it is disbursed as dividends to the shareholders. *Id.* at 27-28 n.5.

8. See, e.g., *Carlson v. Commissioner*, 712 F.2d 1314 (9th Cir. 1983) (taxpayer's sub-

a two-pronged test to determine eligibility.⁹ Both parts of the two-pronged test must be met in order for the ITC to be available to a non-corporate lessor of Section 38 property. The first prong requires that the lessor lease the property for less than half its useful life. The second prong requires the lessor's allowable business deductions related to the lease to exceed fifteen percent of the income generated by the lease.¹⁰ This comment focuses exclusively on the first prong of the part (B) test. This test requires the lease to be for less than half the useful life¹¹ of the property.

Although the short-term lease test appears unambiguous, the Internal Revenue Service (IRS), depending upon the facts of a case, has successfully argued varied interpretations designed to disallow the ITC.¹² The courts have generally given deference to the interpretations of the IRS and disallowed the credit. In particular, disallowance of the ITC has occurred where the lessor and lessee are commonly controlled entities. Section I of this comment traces the background of the ITC and the related noncorporate lessor provision. In section II, two factually similar cases are presented discussing proffer by the IRS of a realistic contemplation test in response to the taxpayer's argument that the terms of the lease document should be respected. The realistic contemplation test provides that lease documents, although complying with the short-term lease test on their face, should be disregarded if the parties realistically contemplated, at the inception of the lease, that the leasing arrangement be continued indefinitely.¹³ Although the test purports to look retrospectively to the time that the lease was made, the IRS proves its case by presenting evidence that the lease actually continued beyond the short-term period.¹⁴

The United States Courts of Appeals for the First and Seventh

contracting of assembly of apple bins, the leased Section 38 property, not sufficient control over processing to be considered manufacture under this section).

9. See *supra* note 6.

10. See, e.g., *Freesen v. Commissioner*, 798 F.2d 195 (7th Cir. 1986); *Seligman v. Commissioner*, 796 F.2d 116 (5th Cir. 1986); *Nelson v. Commissioner*, 793 F.2d 179 (8th Cir. 1986) (cases discussing the 15 percent test).

11. For the purposes of I.R.C. § 46(e)(3), useful life is defined as "the present class life for such property (as defined in Section 168(g)(2))." *Id.* See *infra* note 29 for full text of the statute.

12. The ITC or any tax credit reduces the taxpayer's tax liability for a given year. S. SURREY, P. MCDANIEL, H. AULT & S. KOPPELMAN, *FEDERAL INCOME TAXATION, CASES AND MATERIALS* 505 (1986) [hereinafter S. SURREY]. Disallowing a tax credit restores the tax due to its pre-credit amount. In addition, the taxpayer may owe interest and penalties on any deficiency. *Id.* at 31-33.

13. *Connor v. Commissioner*, 847 F.2d 985 (1st Cir. 1988).

14. *Id.* at 989.

Circuits have disagreed on the proper interpretation of the short-term lease test.¹⁵ The First Circuit Court of Appeals agrees with the realistic contemplation test of the IRS and denies the ITC.¹⁶ In contrast, the Seventh Circuit Court of Appeals gives credence to the terms stated within the lease if the court determines that the lessor retains the economic risk in the transaction. The lessor is then assumed to have made a genuine business investment.¹⁷

Section III of this comment examines two issues raised by the IRS's arguments and the courts' interpretations of the short-term lease test. First, statutory language and the varied interpretations are explored, including the IRS attack on qualification for the ITC by related party owners of lessor and lessee. Second, this section discusses the legitimacy of the recognition by the courts of administrative deference to the IRS in light of the varied tests proposed by the IRS to disallow the ITC.

I. BACKGROUND OF THE ITC AND RESTRICTED AVAILABILITY TO NON-CORPORATE LESSORS

The ITC was first proposed by President Kennedy in 1961¹⁸ and

15. See *McNamara v. Commissioner*, 827 F.2d 168 (7th Cir. 1987).

16. *Connor*, 847 F.2d at 989. In two related decisions following those in *Connor* and *McNamara*, the Eighth and Ninth Circuit Courts of Appeals applied the *Connor* court's realistic contemplation test and distinguished *McNamara* on its facts. See *Owen v. Commissioner*, 881 F.2d 832 (9th Cir. 1989); *McEachron v. Commissioner*, 873 F.2d 176 (8th Cir. 1988) (*Owen* and *McEachron* each challenged disallowance of the ITC on the same facts in different circuits of the courts of appeals).

The realistic contemplation test has also been called the reasonable contemplation or reasonable certainty test. The majority of the Tax Court decisions follow the realistic contemplation test applied in *Connor v. Commissioner*, 847 F.2d 985 (1st Cir. 1988). See, e.g., *Sanders v. Commissioner*, 48 T.C.M. (CCH) 1215 (1984); *Peterson v. Commissioner*, 44 T.C.M. (CCH) 674 (1982); *Ridder v. Commissioner*, 76 T.C. 867 (1981).

17. *McNamara v. Commissioner*, 827 F.2d 168, 172 (7th Cir. 1987).

18. President Kennedy commented in his 1961 President's Recommendations On Tax Revision:

Today, as we face serious pressure on our balance of payments position, we must give special attention to the modernization of our plant and equipment. . . . At the same time, to meet the needs of a growing population and labor force, and to achieve a rising per capita income and employment level, we need a high and rising level of both private and public capital formation. . . . I am now proposing additional incentives for the modernization and expansion of private plant and equipment. . . . [W]e should . . . now [implement the ITC] to strengthen our antirecession program, stimulate employment, and increase our export markets. . . . Specifically, therefore, I recommend enactment of an investment tax incentive in the form of a tax credit . . . [to] be taken as an offset against the firm's tax liability

PRESIDENT'S MESSAGE, HEARINGS BEFORE THE HOUSE WAYS AND MEANS COMMITTEE, 87th Cong., 1st Sess. 3-4 (1961).

enacted in 1962 as a means to stimulate the economy.¹⁹ However, the ITC has had a rather checkered history since its enactment.²⁰ Its repeal or reinstatement has depended upon the state of the economy.²¹ The congressional objective in using the ITC is stimulation of capital investment in order to infuse new life into the economy when it appears to be stagnant or stalled.²²

The ITC is available to businesses for investment in qualified property, and the effect of the ITC is reduction of tax liability.²³ The credit is mandatory and must be taken in the year the property is put in service in order to arrive at the proper tax liability for that year.²⁴ The property must be business property acquired for a profit motive and the taxpayer must have a depreciable interest in the property.²⁵ The amount of the credit taken in one year cannot exceed the tax-

19. S. REP. NO. 1881, 87th Cong., 2d Sess. 7, *reprinted in* 1962 U.S. CODE CONG. & ADMIN. NEWS 3297, 3304.

20. *Id.* (ITC first enacted in 1962). S. REP. NO. 1724, 89th Cong., 2d Sess. 2, *reprinted in* 1966 U.S. CODE CONG. & ADMIN. NEWS 4327, 4328 (repealed in 1966 to combat inflation). S. REP. NO. 79, 90th Cong., 1st Sess. 1, *reprinted in* 1967 U.S. CODE CONG. & ADMIN. NEWS 1198 (reinstated in 1967 when inflationary forces abated). H.R. REP. NO. 413, 91st Cong., 1st Sess. 1, *reprinted in* 1969 U.S. CODE CONG. & ADMIN. NEWS 1645 (repealed in 1969 as part of an overall plan to ensure tax equity). H.R. REP. NO. 533, 92d Cong., 1st Sess. 5, *reprinted in* 1971 U.S. CODE CONG. & ADMIN. NEWS 1825, 1829 (reinstated in 1971, then termed "Job Development Investment Credit," "to bolster the economy and create additional jobs by encouraging expenditures on machinery and equipment which have been sagging badly"). *Id.* H.R. REP. NO. 426, 99th Cong., 2d Sess. 10, *reprinted in* 1986-3 C.B. at 170 (Congressional concern with equity in the tax system where taxpayers have used the credit "to reduce their tax liability to very low percentages of their taxable income"). *Id.*

21. President Kennedy commented in his 1961 President's Recommendations On Tax Revision:

I believe this investment tax credit will become a useful and continuous part of our tax structure. But it will be a new venture and remain in need of review. Moreover, it may prove desirable for the Congress to modify the credit from time to time so as to adapt it to the needs of a changing economy.

PRESIDENT'S MESSAGE, HEARINGS BEFORE THE HOUSE WAYS AND MEANS COMMITTEE, 87th Cong., 1st Sess. 6 (1961).

See, e.g., S. REP. NO. 1881, 87th Cong., 2d Sess. 13, *reprinted in* 1962 U.S. CODE CONG. & ADMIN. NEWS 3297, 3304 (established the ITC at 7 percent); S. REP. NO. 36, 94th Cong., 1st Sess. 3, *reprinted in* 1975 U.S. CODE CONG. & ADMIN. NEWS 54, 57 (increased the ITC to 10 percent).

22. *See supra* note 18.

23. A tax deduction reduces the amount of taxable income to which the tax rate is applied. Alternatively, a credit reduces the tax owed directly, on a dollar-for-dollar basis. Thus, a credit is of greater tax savings benefit. S. SURREY, *supra* note 12, at 505.

24. Rev. Rul. 64-138, 1964-1 C.B. 509-10.

25. S. REP. NO. 1881, 87th Cong., 2d Sess. 16, *reprinted in* 1962 U.S. CODE CONG. & ADMIN. NEWS 3304, 3318-19; H.R. REP. NO. 533, 92d Cong., 1st Sess. 28-29, *reprinted in* 1971 U.S. CODE CONG. & ADMIN. NEWS 1825, 1843-44.

payer's tax liability.²⁶ The amount of any unused credit is carried either forward or backward to the appropriate tax years.²⁷

At present, the ITC is generally repealed,²⁸ but I.R.C. Section 46(e)(3)²⁹ remains valid law and currently applies to property ex-

26. The taxpayer first computes his tax, then computes the ITC which is taken as a credit to reduce the tax for which the taxpayer is liable. Credits reduce tax liability on a dollar-for-dollar basis. *See supra* note 23. *See also* PRENTICE HALL INFORMATION SERVICES, 1989 FEDERAL TAX HANDBOOK ¶¶ 1105, 2050 (1989).

The total ITC for the current year is reported on line 8 of Form 3468 titled: Computation of Investment Credit. If the taxpayer has ITCs only for 1988, he completes Form 3468 and enters the appropriate amount from Form 3468 on line 44 of Form 1040. 2 INTERNAL REVENUE SERVICE, PACKAGE X, INFORMATIONAL COPIES OF FEDERAL TAX FORMS 191-95 (1988) [hereinafter VOL. 2 OF PACKAGE X]. Form 1040 is titled: U.S. Individual Income Tax Return 1988. 1 INTERNAL REVENUE SERVICE, PACKAGE X, INFORMATIONAL COPIES OF FEDERAL TAX FORMS 19 (1988) [hereinafter VOL. 1 OF PACKAGE X].

If, in addition to an ITC, the taxpayer has "a 1988 jobs credit . . . , credit for alcohol used as fuel . . . , research credit . . . , low-income housing credit . . . [or] carryback or carryforward of any general business credit," the taxpayer stops at line 8 of Form 3468 and must then complete Form 3800 titled: General Business Credit. VOL. 2 OF PACKAGE X at 191. *See also supra* note 5. The amount from line 8 of Form 3468 is entered on line 1 of Form 3800. The total amount of the General Business Credit available to the taxpayer is computed on Form 3800 and the appropriate amount entered on line 44 of Form 1040. *Id.* at 197-200. *See also* VOL. 1 OF PACKAGE X 19-20, 38 (1988) (illustrating Form 1040 and explaining the procedure for completion of line 44 of Form 1040).

27. "Unused credits for a taxable year can be carried back to each of the three preceding taxable years and then carried forward to each of the 15 following taxable years." H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. II-50, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 4075, 4138.

28. In 1986, I.R.C. § 49 was enacted, repealing the ITC for most property placed in service after December 31, 1985. I.R.C. § 49 provides:

§ 49. Termination of regular percentage

(a) General Rule.—For purposes of determining the amount of the investment tax credit . . . the regular percentage shall not apply to any property placed in service after December 31, 1985.

(b) Exceptions.—Subject to the provisions of subsections (c) [35-Percent reduction in credit for taxable years after 1986] and (d) [Full basis adjustment], subsection (a) shall not apply to the following:

(1) Transition property [defined in section (e)] . . .

(2) Qualified progress expenditure for periods before January 1, 1986. . . .

(3) Qualified timber property. . . .

I.R.C. § 49 (1988).

In addition, ITC carryovers for 1985 and preceding years are allowed. I.R.C. § 39 (1988). Since the credit is non-refundable and may exceed the tax payable for the year in question, Congress has allowed excess amounts of the ITC to be carried forward or backward to other years. *See supra* note 27.

29. I.R.C. § 46(e)(3) states:

(3) Noncorporate lessors. A credit shall be allowed by section 38 [26 U.S.C.S. § 38] to a person which is not a corporation with respect to property of which such person is the lessor only if—

(A) the property subject to the lease has been manufactured or produced by the lessor, or

cepted from the general repeal³⁰ and to resolution of litigation of ITCs taken prior to 1986. In addition, because Congress has a lengthy history of repeal and reinstatement of the ITC, it is conceivable that the ITC will take on a larger or different life at a future date.³¹

Congress enacted the noncorporate lessor provision³² restrictions to the ITC in 1971 to close a tax loophole which allowed passive investors to create leasing partnerships in order to shelter from tax, income unrelated to the ITC transaction.³³ Income is sheltered from tax liability through leasing partnerships because partnership income is not taxed to the partnership, but rather, to each partner as an individual.³⁴ Thus, each partner would own a share of the income generated from the partnership as well as a share of the ITC. For example, a partnership of doctors could purchase and lease Section 38 property. The ITC would reduce tax liability for income from the partnership as well as from their medical practices.³⁵

(B) the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property, and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162 [26 U.S.C.S. § 162] other than rents and reimbursed amounts with respect to such property) exceeds 15 percent of the rental income produced by such property.

In the case of property of which a partnership is a lessor, the credit otherwise allowable under section 38 [26 U.S.C.S. § 38] with respect to such property to any partner which is a corporation shall be allowed notwithstanding the first sentence of this paragraph. For purposes of this paragraph, an S corporation shall be treated as a person which is not a corporation. This paragraph shall not apply with respect to any property which is treated as section 38 [26 U.S.C.S. § 38] property by reason of section 48(a)(1)(E) [26 U.S.C.S. § 48 (a)(1)(E)]. For purposes of subparagraph (B), in the case of any recovery property (within the meaning of section 168 [26 U.S.C.S. § 168]), the useful life shall be the present class life for such property (as defined in section 168(g)(2) [26 U.S.C.S. § 168(g)(2)]).

I.R.C. § 46(e)(3)(B) (1988).

30. See *supra* note 28.

31. See *supra* notes 19-22 and accompanying text.

32. I.R.C. § 46(e)(3) (1988).

33. Congress intended that the ITC be limited to real investment and that there be a real business motive for a lease. H.R. REP. NO. 533, 92d Cong., 1st Sess. 28-29, *reprinted in* 1971 U.S. CODE CONG. & ADMIN. NEWS 1825, 1843-44.

[M]aking the credit available to the lessor is desirable, as a general rule. . . . Nevertheless, . . . [the committee] is concerned about the extent to which individuals (singly or as a group in a joint venture) are able to utilize the tax benefits of leasing transactions . . . as a means to shelter from tax a substantial part of their other income.

Id.

34. See *supra* note 7 comparing the effect of corporate and partnership ownership of a company.

35. *Connor v. Commissioner*, 847 F.2d 985, 987 (1st Cir. 1988).

To ensure that those legitimate business lessors not falling within the test would not be fully denied the benefit of the ITC, Congress provided that the lessor may elect to pass the ITC through to the lessee. "Even though an individual lessor . . . is denied the credit, he may still elect to pass it through to the lessee. In this manner the credit is not denied to the acquisition itself, but simply to the lessor."³⁶ This means that the lessor, denied the credit, can take pass-through of the credit into account when forming the lease. The credit is, in effect, sold along with the lease, and a lessee will theoretically pay a larger rental for lease of equipment that comes with an ITC.

The following section explores the Commissioner's and taxpayers' arguments and the treatment provided the short-term lease test in the courts of appeals. Two courts of appeals' decisions³⁷ are presented to show the conflict as to the interpretation of the short-term lease test. The issue is whether, in factually similar circumstances, the lease document should be respected rather than application of subjective tests that cause the lease to be disregarded.³⁸

36. H.R. REP. NO. 533, 92d Cong., 1st Sess. 30, reprinted in 1971 U.S. CODE CONG. & ADMIN. NEWS 1825, 1845. See also I.R.C. § 48(d) (1988).

37. *Connor v. Commissioner*, 847 F.2d 985 (1st Cir. 1988); *McNamara v. Commissioner*, 827 F.2d 168 (7th Cir. 1987).

38. There is substantial precedent for disregarding the form of the lease in favor of the substance of the transaction. See *Highland Hills Swimming Club, Inc. v. Wiseman*, 272 F.2d 176 (10th Cir. 1959). In accord, *G. W. Van Keppel Co. v. Commissioner*, 295 F.2d 767 (8th Cir. 1961); *Buddy Schoellkopf Prods., Inc. v. Commissioner*, 65 T.C. 640 (1975). In *Highland Hills*, the partnership taxpayer built a swimming pool and leased it to a related corporation which owned and managed an adjacent health club. The major issue in this case was whether stated terms in leases should be controlling for tax purposes when determining the depreciable life of the swimming pool. *Highland Hills*, 272 F.2d at 179. The court stated: "[I]n determining the character of any transaction or arrangement for tax purposes the substance rather than the form is controlling. . . . That leases or terms of leases may be disregarded under this principle is clear." *Id.* at 180. The court held that the lease was, in substance, of indefinite duration. *Id.*

The result of this ruling was that the taxpayer's attempt to depreciate the property over the term of the lease was disallowed. "If the stated period of the lease is not recognized and the lease is found to be of indefinite duration the improvement must be depreciated over its useful life." *Id.* at 179. Thus, the court required that the pool's cost of nearly \$54,000 be amortized over its 20-year useful life rather than over the 100 month (8.33 year) term of the lease. *Id.* at 180.

In *Highland Hills* the court considered four factors of particular importance in determining the lease to be of indefinite duration: "the relationship of the parties concerned; failure of the taxpayer to pay all of the rental; the fact that the swimming pool was an integral part of the club; and the cost of the improvements made by the taxpayer." *Id.* at 179. Of these, the court perceived the relationship of the parties to the transaction or their common control as the major factor in assessing whether to ignore the stated term of the lease:

[T]he fact that the stockholders of the corporations involved are identical or related makes possible the continuation of the present lease arrangement as long as

II. INTERPRETING THE SHORT-TERM LEASE TEST

Despite the criteria that the short-term lease test provides for ITC qualification for noncorporate lessors, the proper interpretation of the short-term lease test is unresolved. The statute provides in part that "the term of the lease (taking into account options to renew) . . . [must be] less than 50 percent of the useful life of the property."³⁹ The Commissioner and taxpayers take different positions as to what this language means. In this dispute, the Commissioner contends that the substance of the leasing transaction is actually a lease of indefinite duration. He argues that, despite the written terms of the lease, the parties realistically contemplated that the lease would last beyond half of the property's useful life when the lease was made and such a transaction does not qualify for the ITC within the terms of the statute.⁴⁰ The taxpayers, by contrast, argue that because legitimate business purposes support creation of a separate entity to serve as lessor to that entity's related companies and because obtaining a better tax result is not the primary motive behind formulation of the leasing transaction, the terms of their written leases, which comply with the short-term lease test, should be respected.⁴¹ The approaches taken by the Seventh and First Circuits to resolve this controversy over the interpretation of the short-term lease test differ radically, but illustrate the competing issues and concerns of the parties and of the courts.

A. *McNamara v. Commissioner*⁴²

In *McNamara*, the non-corporate lessor claimed the ITC on its individual returns for the years 1977, 1978, and 1979 on the assumption that they were in compliance with the conditions of I.R.C. Section 46(e)(3)(B).⁴³ The taxpayers formed a partnership, D & B Associates (D & B), in 1968,⁴⁴ for the dual purpose of meeting their equipment needs without increasing liabilities and of diversifying their assets to better cope with the economic swings which affect the construction

it is advantageous. . . . [This] has been borne out in practice. . . . And the continuance as long as it is advantageous is, of course, characteristic of an indefinite lease.

Id. at 180.

39. I.R.C. § 46(e)(3)(B) (1988). See *supra* note 29 for the full text of the statute.

40. *McNamara*, 827 F.2d at 169-70; *Connor*, 847 F.2d at 989.

41. *McNamara*, 827 F.2d at 172; *Connor*, 847 F.2d at 987.

42. 827 F.2d 168 (7th Cir. 1987).

43. *Id.* at 169.

44. Donald G. McNamara and Robert F. Christiansen each owned a one-half interest in the partnership. Both McNamara and Christiansen challenged disallowance of the ITC by the IRS. Amounts at issue are as follows:

business.⁴⁵ D & B purchased the Section 38 property, took advantage of the ITC, and leased the property to a related corporation, F.J.A. Christiansen Roofing Co., Inc. (Roofing).⁴⁶ The leases were for a fixed term, less than half the useful life of the property, and contained no option to renew. In addition, the parties renegotiated the leases⁴⁷ for successive periods at different terms.⁴⁸

	McNamara,	Christiansen,
1977	\$2,804.00	\$2,804.00
1978	7,307.00	7,307.00
1979	6,300.00	6,811.00

McNamara v. Commissioner, 51 T.C.M. (CCH) 1464 (1986).

45. F.J.A. Christiansen:

had a low net worth and limited working capital and was reluctant to incur additional indebtedness because the existence of excessive liabilities on its balance sheet would severely impede its ability to obtain bid bonds necessary to bid on construction projects. . . .

[T]he taxpayers were also motivated by a desire to acquire some assets which would be insulated from the risks and seasonal swings of the construction business. . . . [I]n addition . . . D & B owns real estate which it leases to another related company and has invested in stock and in partnerships involved in oil and gas activities.

McNamara, 827 F.2d at 169.

46. Stock ownership of F.J.A. Christiansen Roofing Co., Inc. was as follows:

Stockholder	Voting Class A Common Stock	Nonvoting	Preferred Stock
		Class B Com- mon Stock	
Donald McNamara	50 %	39%	0
Robert F. Christiansen	33.8%	5%	0
Christiansen Family Trust	16.2%	56%	0
Joyce Church	0	0	100%
Totals	100 %	100%	100%

McNamara, 51 T.C.M. (CCH) at 1465. Thus 83.8% of the voting stock in the corporation (a controlling amount) is owned by Donald McNamara and Robert F. Christiansen, the partners of D & B Associates. McNamara, 827 F.2d at 169.

47. See McNamara, 51 T.C.M. (CCH) at 1465-67 for details of the lease provisions. Section 38 property at issue included:

equipment	year of acquisition	useful life
1. Mack Truck	1977	8 years
2. Toshiba Copier	1977	8 years
3. Mack Truck	1978	5 years
4. 35-ton P & H hydraulic truck crane	1979	10 years
5. 25-ton Grove hydraulic truck crane	1978	10 years

Id. at 1465-66.

48. Stated lease terms were revised, the rental rates were reduced, allocation of expenses between the parties was adjusted, and options to purchase were eliminated. McNamara, 51 T.C.M. (CCH) at 1465-67.

The Commissioner disallowed the ITC and assessed a deficiency. D & B argued to the Tax Court that the face of the written lease should be respected and the ITC allowed. In opposition, the Commissioner argued the realistic contemplation test. He countered that there was a reasonable certainty that the lessor would continue to use the leased equipment beyond the stated term of the lease and that the leases were, in fact, of indefinite duration.⁴⁹ The Tax Court accepted the Commissioner's argument and affirmed the disallowance of the ITC.⁵⁰ D & B appealed the Tax Court decision.

On appeal, the Seventh Circuit Court of Appeals reversed the Tax Court's decision. The court held that where there are "legitimate economic and business considerations" and where tax avoidance is not the primary motive behind the transactions, then short of the Commissioner showing the lease transaction to be a "sham," a lease document satisfying the short-term lease test should be respected and the ITC allowed.⁵¹ Further, the court determined that, based on the written terms of the lease, D & B retained the active business risks associated with the lease transaction. Such risks included the possibilities that the value of the equipment might decline, that the lessees might lose the continued ability to pay, and that the equipment might need to be re-leased.⁵²

In rejecting the Commissioner's realistic contemplation test, the Seventh Circuit reviewed the legislative history of Section 46(e)(3)(B) and, without elaboration, noted that the Commissioner's real concern appeared to be evasion of taxes through common ownership of parties to lease transactions.⁵³ The court determined that Congress enacted Section 46(e)(3)(B) to prevent use of the ITC as a tax shelter for passive investors. To this end, the short-term lease test "is designed to ensure that the lessor bears much of the economic risk of the prop-

49. *McNamara*, 827 F.2d at 169-70.

50. Evidence relied upon by the Tax Court included: 1) D & B's purchases were made specifically to meet the needs of Roofing; 2) Roofing's cost by leasing from D & B was less than if a third-party lessor were used; 3) there were no subsequent changes in the financial situation of Roofing allowing purchase of its own equipment; 4) D & B leased only to related parties; and 5) D & B and Roofing were commonly owned. *McNamara*, 827 F.2d at 171, 51 T.C.M. (CCH) at 1468-69.

51. *McNamara*, 827 F.2d at 172.

52. *Id.* at 171.

53. *Id.* at 172 n.5. The court further stated that Section 482 of the Internal Revenue Code gives the Commissioner authority to reallocate credits between commonly owned entities to prevent tax evasion or to clearly reflect income. But, the Commissioner has never used that power "to reallocate the investment tax credit in cases involving leasing transactions among related entities." *Id.*

erty.”⁵⁴ The court specifically rejected the Commissioner’s realistic contemplation test:

The fact that the lessor and lessee may realistically contemplate continuous renewal of a lease certainly cannot afford the lessor the same kind of protection [from economic risk] as a binding commitment to renew on identical or essentially similar terms.^[55] The principal economic risk associated with the ownership of rental property is the risk of a dramatic reduction in expected rental income To insulate itself from this risk . . . a lessor must enter into a long-term lease which obligates the lessee to pay a fixed amount of rent over the entire useful life of the property. Short of such an arrangement, the lessor will continue to bear at least some risk associated with ownership of the property.⁵⁶

Thus, without some guarantee or expectation of renewal on the same or similar terms, even where the parties are commonly controlled or may have reasonably contemplated at the inception of the lease transactions that the lease would be continuously renewed, the lessor retains the risks of ownership of the property.

Based primarily on its assessment of congressional intent in enacting Section 46(e)(3)(B)—that emphasis be placed on retention of business risk where there are legitimate economic and business considerations underlying the leasing transactions—the court concluded:

At least in cases involving leasing activity that is not primarily tax motivated, where the stated lease term in a written lease document satisfies the 50 percent requirement, that document should be respected, and unless the Commissioner can demonstrate that the lease is a “sham,” *i.e.*, that there has been a real shifting of all economic risk associated with the leased property from the lessor to the lessee, the lessor is entitled to claim an investment tax credit for the property⁵⁷

In further support of its contention that retention of risk be determinative of a short-term lease transaction, the court provided that the

54. *Id.* at 170.

55. Leases containing a binding commitment to renew on identical or substantially similar terms or containing options to renew may be aggregated. *See* Rev. Rul. 76-266, 1976-2 C.B. 10, 11. This revenue ruling governs circumstances in which successive leases are aggregated and considered as one lease. Leases may be aggregated where either concurrent agreements to lease for successive periods which extend beyond 50% of the useful life of the property and/or options to renew are found. However, the rule favors *not* aggregating leases in which there is real negotiation of the terms of the new leases or retention by the lessor of some of the economic risk associated with the property. *Id.*

56. *McNamara*, 827 F.2d at 171.

57. *Id.* at 172.

Commissioner must show the lease to be effectively long-term. “[A]t minimum there must be a fixed intention that the lease will be continuously renewed on the same or substantively identical terms” to prove the lease transaction is a “sham.”⁵⁸

B. *Connor v. Commissioner*⁵⁹

In *Connor*, a case factually similar to *McNamara*, the First Circuit Court of Appeals followed the majority of the Tax Court decisions⁶⁰ in specifically disagreeing with the *McNamara* approach and accepting the Commissioner’s argument that the realistic contemplation test should be applied. As a result, the court determined that the lease transaction was, in substance, of indefinite duration and the taxpayer was disallowed the ITC.

In *Connor*, Sunset Construction Company (Sunset), a partnership,⁶¹ was formed to buy and lease heavy construction equipment to two related companies.⁶² In 1979 and 1980, one of the partners, Eugene R. Connor, claimed an ITC on his personal income tax return⁶³ for the Section 38 property purchased for the purpose of leasing. The

58. *Id.* The court vacated the decision of the Tax Court and remanded for the limited purpose of determining if any of the five leases were “shams” using the test given. On remand, the Tax Court determined that four of the five leases were not “shams.” The fifth lease was also remanded for the purpose of determining if the 15% test of I.R.C. § 46(e)(3)(B) was met. The court determined that the test was not met, obviating the necessity of reaching the issue of a “sham” for this one lease. *McNamara v. Commissioner*, 55 T.C.M. (CCH) 401 (1988).

59. *Connor v. Commissioner*, 847 F.2d 985 (1st Cir. 1988).

60. *See supra* note 16.

61. *See supra* note 7 and accompanying text for an explanation of the effects of the partnership form of ownership.

62. Ownership of Sunset Construction Company was in the form of a general partnership owned equally by Eugene R. Connor and his brother, John H. Connor III. The brothers were each 50% shareholders in the related companies, Connor Construction Corporation (Connor Co.) and Catamount Construction Corporation (Catamount). *Connor v. Commissioner*, 53 T.C.M. (CCH) 724, 725 (1987). “In 1979, Sunset purchased 19 pieces of equipment at a total cost of \$604,478. In 1980, Sunset purchased additional equipment at a total cost of \$115,022.” *Id.* at 726. The Section 38 property purchased was primarily heavy construction equipment. Smaller pieces of equipment were generally purchased directly by Connor Co. and Catamount. *Id.* at 725-26.

63. Eugene R. Connor and his wife, Mary P. Connor, filed joint tax returns for the years in question. The Investment Tax Credits claimed on the Connors’ tax returns are as follows:

Year	Deficiency
1976	\$ 7,669.00
1977	1,013.82
1978	11,872.18
1979	7,147.80
1980	4,781.00

Commissioner disallowed the ITC, arguing that it was reasonably certain that the leases would last far longer than the stated term resulting in noncompliance⁶⁴ with the short-term lease test.⁶⁵ The taxpayer countered, arguing that the terms of the written leases should be respected. The Tax Court accepted the Commissioner's realistic contemplation argument, determined the leases to be in substance of indefinite duration,⁶⁶ and affirmed disallowance of the ITC. Connor appealed the decision of the Tax Court to the First Circuit Court of Appeals.

On appeal, the First Circuit Court of Appeals in *Connor* affirmed the Tax Court decision. The court approached its analysis of the short-term lease test by first reviewing the decision reached in *McNamara*. The court determined that under the *McNamara* test⁶⁷ the taxpayer would prevail because, as conceded by the Commissioner, Connor's motives for entering into the leasing transactions were valid business reasons and not part of a tax avoidance scheme.⁶⁸ However, the court disagreed both with the taxpayer's arguments and with the *McNamara* court's interpretation of the short-term lease test. The court gave four reasons for its disagreement with the *McNamara* decision: statutory analysis; purpose of the statute; administerability of the tax code; and deference to the Commissioner's interpretation of the

Id. at 724-25. Only the leases and corresponding tax credits for the years 1979 and 1980 were at issue. These totaled \$11,928.80 in value. *Id.* at 726.

64. The written term of the lease was one year; however, the Commissioner found that the leases were actually for a longer period exceeding half the useful life of the property. *Connor*, 847 F.2d at 986.

65. See *supra* note 29 for the text of I.R.C. § 46(e)(3)(B).

66. *Connor*, 847 F.2d at 986.

67. *Id.* at 987.

68. The Connor brothers formed Sunset for two reasons. First, they wanted to avoid being cited for unfair labor practices. The Connors' other two companies, Connor Construction Corp. and Catamount Construction Corp., were respectively unionized and non-unionized:

The simultaneous operation of a union and a non-union construction company, both of which are under common ownership, is referred to as a "double-breasted" operation. Failure to operate the two companies as separate, distinct entities can result in a finding . . . [of] an unfair labor practice.

Inter-company loans and the rental of equipment back and forth between Connor Construction and Catamount might have raised questions over whether the double-breasted operations were separate and distinct.

Connor, 53 T.C.M. (CCH) at 725. Second, bid bonds are commonly required for contractors doing public construction work. Moving fixed assets to the financial statements of Sunset correspondingly removed them from the financial statements of the related companies making those companies appear more liquid and improving their ability to acquire bid bonds. *Id.*

tax code.⁶⁹

In *Connor*, the court interpreted the *McNamara* decision as calling for a strong presumption in favor of a written lease, as requiring an examination of the motives of the lessor and lessee on a case-by-case basis, and as shifting the burden of proof to the Commissioner in contravention of IRS Rules of Practice and Procedure.⁷⁰ The court stated the *McNamara* test as follows:

In *McNamara*, the court interpreted [Section] 46(e)(3)(B) as *requiring* the Commissioner to accept at face value “the stated lease term in a written lease,” at least where (1) the “leasing activity . . . is not primarily tax motivated” and (2) the Commissioner can[not] demonstrate that the lease is a “sham,” i.e., that there has been a real shifting of all economic risk associated with the leased property from the lessor to the lessee.⁷¹

The *Connor* court stated that the language of the statute does not on its face require a *McNamara* test or any other test⁷² and, moreover, that “the statute’s purposes do not seem to call for the strong ‘written lease’ presumption that the [*McNamara* court] has erected.”⁷³

In *Connor*, the court further viewed *McNamara* as requiring that the Commissioner demonstrate the transaction to be a “sham” by directing that “the Commissioner or the courts . . . examine the motives of the lessor/purchaser . . . to decide whether, on all the facts, the lessor/purchaser was a legitimate business. . . .”⁷⁴ *Connor* rejected this subjective approach in favor of its own interpretation of congressional intent, that is, establishment of what the court termed an “ob-

69. *Connor*, 847 F.2d at 987-89. The court focused on evidence showing that the related companies were likely to receive one of the many jobs that they bid upon where the leased equipment would be used. The companies were closely related, and Sunset was created specifically to meet the needs of the lessees. There were no past rentals or sales to third parties, and the lessees leased from third party lessors only after Sunset’s business decision not to meet the lessee’s needs through purchase of the equipment to lease to the related companies. *Id.* at 991.

70. *Id.* at 987-88. IRS Rules of Practice and Procedure are public statements of internal practices and procedures. S. SURREY, *supra* note 12, at 21.

71. *Connor*, at 987 (quoting *McNamara*, 827 F.2d at 172).

72. In fact, the language of the statute says simply that “the term of the lease (taking into account options to renew) . . . [must be] less than 50 percent of the useful life of the property.” I.R.C. § 46(e)(3)(B) (1988). See *supra* note 29 for the full text of the statute.

Thus, the *Connor* court analyzed the statute concluding that the language of the statute does not require any specific test because the words “term” and “offer to renew” are not specifically defined in the statute. The manner in which these may be shown is left to the court’s interpretation. *Connor*, 847 F.2d at 987.

73. *Id.*

74. *Connor*, 847 F.2d at 987 (citing *Ridder v. Commissioner*, 76 T.C. 867, 872 (1981) (“hard and fast” test adopted by Congress for determining eligibility)).

jective test" based on the length of the lease as determined by the realistic contemplation test. The court stated that the purpose of the statute was to discourage passive investment by "persons *not* genuinely in the leasing business, say, partnerships of doctors, or lawyers, or dentists, to obtain for themselves the benefits of the ITC"⁷⁵ thereby sheltering other income from tax. Instead, Congress chose to encourage real investment by firms in fact in the leasing business.⁷⁶ To that end, Congress enacted the short-term lease test which the court determined was designed to focus on the nature of the lease, rather than on the underlying motives of the lessor or the lessee.⁷⁷ In the court's view, the short-term lease test established objective criteria based on "lease-life."⁷⁸

As further support for its contention that Congress did not intend examination of the motives of the lessor and lessee on a case-by-case basis, the court pointed out that Congress recognized that there would be legitimate professional lessors who would not meet the test.⁷⁹ To accommodate those lessors and to preempt case-by-case analysis, Congress "permit[ted] a disqualified lessor . . . to pass on the ITC to the leasing firm, which can then itself use the credit."⁸⁰

Further, the court held the *McNamara* test too difficult to administer for two reasons.⁸¹ First, the test requires examination of the lessor's motives on a case-by-case basis. Second, the test shifts the burden of proof to the Commissioner if there is a written lease complying on its face with the short-term lease test and no tax avoidance motive is found. The court stated that "Congress . . . [wrote] a general rule based on the length of the lease, [and did] not . . . order case-by-case risk assessment."⁸² This general rule is easier to administer because making the written lease determinative of the term of the lease can allow manipulation⁸³ by the parties, especially where the parties are commonly controlled,⁸⁴ because the lessor controls the amount of

75. *Connor*, 847 F.2d at 987. See *supra* notes 32-35 and accompanying text.

76. *Connor*, 847 F.2d at 987.

77. *Id.* at 988.

78. *Id.* at 987.

79. *Id.* at 988.

80. *Id.* See *supra* note 36 (I.R.C. § 48(d) (1988) allows the lessor to pass the ITC on to the lessee).

81. *Connor*, 847 F.2d at 988.

82. *Id.*

83. "If a lessor has complete control of a lessee, the 'risk' it chooses to shift is also under its control. It can draft either long-term, or short-term, leases to impose risks in a host of different ways, all without changing their duration." *Id.*

84. The *Connor* court is especially concerned here because the subject written leases were executed after the fact on the advice of an accountant. *Id.*

risk that it shifts to the lessee.⁸⁵

Further, on the issue of administerability, the court stated that shifting the burden of proof to the Commissioner as provided in the *McNamara* test⁸⁶ goes against the IRS's procedural rules. Discussing burden of proof requirements, the court stated:

[A]llowing the Commissioner to prove that a lease is a sham . . . means that, given a lease with the right language, the Commissioner rather than the taxpayer effectively bears the burden of proof. The Commissioner must demonstrate that the lease is a sham, presumably by using many of the same factors that the taxpayer previously had to use to show his or her "realistic contemplation." This result cuts against the spirit of Rule 142(a).⁸⁷

Finally, the *Connor* court gave deference to the Commissioner's interpretation of the short-term lease test for two reasons.⁸⁸ First, the court recognized the Commissioner's expertise in interpreting the complex statutory provisions of the tax law. Second, the court stated that consistent interpretation of a statute is entitled to the court's respect. Thus, the *Connor* court paid deference to the Commissioner's interpretation of the statute and applied his realistic contemplation test: "the taxpayer must show that the parties, when they made the lease, 'realistic[ally] contempl[ated]' that the lease would cover less than 50 percent of the property's useful life."⁸⁹ The court determined that the Connors failed to meet this test and that the leases were actually of indefinite duration. Thus, the court disallowed the ITC.

III. ANALYSIS

The First and Seventh Circuits' approaches to the interpretation of the short-term lease test are quite different. This section analyzes these conflicting interpretations, discussing the statutory language and congressional intent, application of the short-term lease test in those transactions where the taxpayer has common ownership or control of the lessor and lessee, and the subjective versus objective nature of the proffered tests. This section also explores the concept of deference to the IRS administrative agency and discusses why the court in *Connor*,

85. *Id.*

86. *Id.* (citing *McNamara*, 827 F.2d at 172).

87. *Id.* at 988. "Tax Court Rules of Practice and Procedure, 26 U.S.C. foll. § 7453 [(1982)] (taxpayer bears burden of proof in protesting deficiency assessed by Commissioner)." *Id.*

88. *Id.* at 989.

89. *Id.* (citing *Hokanson v. Commissioner*, 730 F.2d 1245, 1248 (9th Cir. 1984); *Ryder v. Commissioner*, 76 T.C. 867, 875 (1981)).

based on accepted standards for deference, was incorrect in deferring to the Commissioner's interpretation of the short-term lease test. This section concludes with a discussion of the interpretation of the short-term lease test which best effectuates the intent of Congress.

A. *Comparison of the McNamara and Connor Decisions*

The *McNamara* and *Connor* decisions agree in two important respects. First, both courts agree that the congressional purpose of the ITC was to discourage passive investors from using the ITC and, conversely, to encourage active investment by non-corporate lessors.⁹⁰ Thus, to benefit from the ITC, Congress required that non-corporate lessors lease the Section 38 property for less than half of its useful life.⁹¹ Second, pursuant to the *McNamara* rationale, the taxpayers in both cases would be allowed to take the ITC.⁹²

In contrast, the courts' opinions diverge strongly in interpreting and applying the intent of Congress. The *McNamara* court interpreted this purpose as a requirement that the lessor bear the economic risk of the transaction⁹³ and required the Commissioner to show the transaction to be a "sham."⁹⁴ The *Connor* court interpreted the congressional objective as discouragement of passive investment by those "not genuinely in the leasing business"⁹⁵ and applied its objective test based upon the actual length of the lease.⁹⁶ The courts further disagreed on the importance of common control in applying the short-term lease test and on the degree of deference owed the Commissioner's interpretation.⁹⁷

The language of a statute is the first place a court should look in determining whether an interpretation is appropriate. It is a well established canon of statutory interpretation that where the words of the statute are clear they should be applied as written.⁹⁸ The statute calls

90. *McNamara*, 827 F.2d at 170; *Connor*, 847 F.2d at 987.

91. "[T]he term of the lease (taking into account options to renew) . . . [must be] less than 50 percent of the useful life of the property." I.R.C. § 46(e)(3)(B) (1988). See *supra* note 29 for the full text of the statute.

92. *McNamara*, 827 F.2d at 172; *Connor*, 847 F.2d at 987.

93. See *supra* notes 54-56 and accompanying text.

94. See *supra* note 58 and accompanying text.

95. *Connor*, 847 F.2d at 987. See *supra* notes 74-80 and accompanying text.

96. See *supra* notes 77-78 and accompanying text.

97. See *infra* notes 123-55 and accompanying text for analysis of the issue of deference to an administrative agency (the IRS) when interpreting the short-term lease test.

98. T. SEDGWICK, A TREATISE ON THE RULES WHICH GOVERN THE INTERPRETATION AND CONSTRUCTION OF STATUTORY AND CONSTITUTIONAL LAW 195 (2d ed. 1874) (quoting the United States Supreme Court in *Fisher v. Blight*, 6 U.S. (2 Cranch) 358, 399 (1805): "Where a law is plain and unambiguous . . . the legislature should be intended to

simply for a lease which extends for less than half of the useful life of the leased property. This is an objective standard which appears to look only to the lease document. "Congress thus chose reasonably clear requirements upon which the taxpayer, the [IRS], and the courts could rely in determining the propriety of a lessor's retention of the credit. . . . Although the rule [Section 46(e)(3)(B)] was initially interpreted by the courts and the [IRS] fairly literally [] current interpretations have superimposed subjective criteria on it. . . ."99 Thus, as a threshold, there must exist a written lease document which complies with the statute.

The next source in interpreting a statute is the legislative history. "Congressional meaning is of course ordinarily to be discerned in the words Congress uses. But when the literal application of the imprecise words . . . Congress employed . . . produces . . . extraordinary results . . . we should determine whether this meaning is confirmed in the legislative history of the section."¹⁰⁰ The issue is whether application of the Commissioner's realistic contemplation test effectuates the congressional intent to discourage passive investors from availing themselves of the ITC. Congress intended that the ITC be limited to real investment and that there be a real business motive¹⁰¹ for a lease:

[M]aking the credit available to the lessor is desirable, as a general rule. . . . Nevertheless, . . . [the committee] is concerned about the extent to which individuals (singly or as a group in a joint venture) are able to utilize the tax benefits of leasing transactions . . . as a means to shelter from tax a substantial part of their other income.¹⁰²

In *Connor*, the court justified acceptance of the Commissioner's realistic contemplation test by stating that where entities are commonly controlled there is greater opportunity for manipulating a

mean what they have plainly expressed, and consequently no room is left for construction.").

99. Vitale, *Note—Noncorporate Lessors' Retention of the Investment Tax Credit Following Recent Judicial Interpretations of Section 46(e)(3)(B)*, 37 TAX LAW. 187, 190-91 (1984) (footnote omitted) [hereinafter VITALE]. This note focused on early, 1980-1982, Tax Court decisions concerning I.R.C. § 46(e)(3)(B) from a tax planning perspective. The author discussed *Ridder v. Commissioner*, 76 T.C. 867, 872 (1981), where the Tax Court upheld the lease document and chose not to interfere with the congressional choice of "hard and fast" tests for retention of the ITC. *Id.*

100. *NLRB v. Allis-Chalmers Mfg. Co.*, 388 U.S. 175, 184 (1967).

101. H.R. REP. NO. 533, 92d Cong., 1st Sess. 28-29, reprinted in 1971 U.S. CODE CONG. & ADMIN. NEWS 1825, 1843-44.

102. *Id.*

transaction to fit within the strictures of the Code.¹⁰³ Congress does not address common control of a lessor and lessee directly in the wording of the statute, nor indirectly in the congressional history. However, common control of the lessor and lessee is a factor in the majority of the Tax Court cases and in the courts of appeals cases discussed in this comment that litigate the validity of non-corporate lessors taking an ITC. Both the *McNamara* and *Connor* courts discuss the lessor and lessee as commonly controlled entities. The *McNamara* court addresses common control directly stating that, in fact, the Commissioner's real concern in these cases is the common control factor.¹⁰⁴

The Commissioner's argument for the realistic contemplation test was rejected in a recent Tax Court case, *Sauey v. Commissioner*,¹⁰⁵ where the Tax Court changed its approach to the short-term lease test.¹⁰⁶ In *Sauey*, the taxpayer partnership purchased and leased two successively owned airplanes to its related corporation. The Commissioner sought to aggregate the leases for both airplanes and deny the ITC of \$133,902 taken in 1981. While generally supporting the *McNamara* court's approach, the *Sauey* court reexamined burden of proof and evidence issues and stated that the taxpayers must bear the burden of proof as to whether the lease is short-term. This requirement is met by showing a short-term lease of fixed duration with no options to renew. The burden of proof then shifts to the Commissioner.¹⁰⁷

Departing from both the *Connor* and *McNamara* approaches, the court in *Sauey* stated that the Commissioner may meet the burden of proof by arguing reasonable certainty and producing further evidence that the leases were of indefinite duration.¹⁰⁸ The additional evidence required included, for example, automatic renewal of leases on the same terms with no negotiation, purchase and resale of leased equipment to satisfy the needs of the related party, and evidence that the transaction was formed primarily for tax purposes.¹⁰⁹ The *Sauey* court concluded by stating:

[The Commissioner's] real concern in this case appears to be that

103. *Connor*, 847 F.2d at 988.

104. *McNamara*, 827 F.2d at 172 n.5.

105. 90 T.C. 824 (1988). *Accord* Borchers v. Commissioner, 55 T.C.M. (CCH) 1469 (1988) (but noting the *Connor* court's disagreement).

106. *Sauey*, 90 T.C. at 827-28.

107. *Id.* at 827.

108. *Id.* at 829-30.

109. *Id.* at 828-30.

. . . [the lessor and lessee] are related parties. We recognize that in leasing transactions involving related parties there is a clear potential for abuse. However, Congress did not see fit to deny the investment credit to noncorporate lessors who are related to their lessees, even though it easily could have done so. . . . Rather, Congress simply imposed two hard-and-fast tests . . . [the two-prong test of Section 46(e)(3)(B)], and provided that *all* noncorporate lessors of property eligible for the investment credit are entitled to the credit if they satisfy these two tests.¹¹⁰

The Commissioner closely scrutinized common control of the lessor and the lessee or related party transactions for compliance with the short-term lease test.¹¹¹ There is an implied aura of suspicion that by employing related business entities, a taxpayer is actually employing tax evasion techniques. This premise ignores the fact that tax law does not preclude formation of a business with awareness of the tax structure.¹¹²

If, as stated in both *McNamara* and *Sauey*, the Commissioner's real concern in these cases is common control of the lessor and the lessee, it follows that acceptance of the Commissioner's realistic contemplation test in *Connor* may be justified as a means of preventing these entities from improperly manipulating the short-term lease test because the realistic contemplation test can be applied broadly to disallow all such related party transactions. Thus, in effect, the Commissioner is targeting these entities for using the ITC as a conduit to shelter other income from tax, clearly a forbidden use of the ITC according to congressional intent. The problem with using the short-term lease test in this manner is that Congress did not intend to forbid the ITC to these lessors.¹¹³ Congress had the ability to limit use of the

110. *Id.* at 829.

111. Close scrutiny takes the form of court review of a number of variables to assess whether the transaction has the components of arms length dealing. For example, in *Connor*, the court looked for leasing transactions conducted with outside or third parties by the lessor, the lessee seeking alternative leasing arrangements, lessor purchase of equipment specifically for the needs of the lessee and resale of equipment motivated solely by the needs of the lessee. *Connor*, 847 F.2d at 990.

112. *Sauey*, 90 T.C. at 829. "To be sure, we have no doubt that . . . [Sauey] was aware of the tax consequences of his leasing activities. However, we have never held that persons engaged in business activities must be ignorant of the tax benefits resulting from those activities in order to be eligible for such benefits." *Id.* See generally Dosart, *Tax court raises section 46(e)(3) hurdle for non-corporate lessors attempting to claim ITC*, 58 J. TAX'N 100 (1983) (observing in a factually similar case, *Peterson v. Commissioner*, 44 T.C.M. (CCH) 674 (1982), see *supra* note 16: "[t]he fact pattern here suggests too strongly a tax savings motivation. . . . The Tax Court seems to overlook the fact that all good business deals involve a perceived benefit by both parties to the deal.") *Id.* at 102.

113. *Sauey*, 90 T.C. at 829.

ITC to leasing transactions between independently controlled non-corporate entities. In fact, Congress chose not to do so.

As further evidence that Congress did not intend that the short-term lease test be used, beyond its scope, as a weapon against tax shelters formed by commonly controlled entities, Congress has enacted statutes which specifically address the issue of abusive tax shelters.¹¹⁴ These are the tools which Congress has provided to the Commissioner to disallow such shelters. For example, I.R.C. Section 482 "authorizes the Commissioner to reallocate credits between ' . . . businesses . . . owned or controlled directly or indirectly by the same interests' if necessary to prevent evasion of taxes or clearly to reflect income."¹¹⁵

In addition, the tests created by both *Connor* and *McNamara* require imposition of a subjective case-by-case analysis of the facts. In *McNamara*, the court formulates its own test which first accepts the lease on its face, but then emphasizes a determination, with the Commissioner bearing the burden of proof, as to whether the lessor is actually in the business of leasing. This is ascertained by analyzing whether the lessor has retained the economic risk associated with the transaction.¹¹⁶ The *Connor* court terms the *McNamara* approach subjective because it requires review of the lessor's motives in each case. The *Connor* court finds particular fault, from both a deference and administrative convenience point of view, with the *McNamara* requirement that the burden of proof shift to the Commissioner once economic risk is established.¹¹⁷ Further, the *Connor* court finds no specific test embodied in the statute, and so, in deference to the Commissioner, opts for his interpretation which is the realistic contemplation test.¹¹⁸ The Commissioner's realistic contemplation test requires that "the taxpayer . . . show that the parties, when they made the lease, 'realistic[ally] contempl[ated]' that the lease would cover less than 50 percent of the property's useful life."¹¹⁹

Although on a superficial level the realistic contemplation test appears to be objective, it is defective because in application, the test as used in *Connor* requires a case-by-case analysis, as does the *McNamara* court's motive analysis test. For that reason, *Connor* does not provide an administratively easier solution. Examining either contemplation by the taxpayer or his motives involves determining what the

114. I.R.C. § 482 (1988). See also *McNamara*, 827 F.2d at 172 n.5.

115. I.R.C. § 482 (1988).

116. *McNamara*, 827 F.2d at 171-72.

117. *Connor*, 847 F.2d at 988-89.

118. *Id.* at 989. See *supra* notes 73-78, 88-89 and accompanying text.

119. *Connor*, 847 F.2d at 989.

taxpayer was considering when making the lease; a far departure from the clear wording of the statute or the intent of Congress. Contemplation is defined as "an act of the mind in considering with attention . . . the act of intending or considering a future event."¹²⁰ A motive is "the consideration or object influencing a choice or prompting an action."¹²¹ Examining the leasing transaction after the fact is subjective because the same evidence is used by the Commissioner to prove non-compliance with the short-term lease as by the taxpayer to show compliance. The evidence is subjective because, as mustered by the IRS, it may be molded to fit the test. Indeed, it would be difficult for the honest taxpayer, who intended and created a short-term lease, to rebut the government's conclusory evidence that the parties realistically contemplated a long-term arrangement when that lease, by circumstance alone, became long-term.

In sum, Congress provided a clearly worded objective two-part test for determining a valid lease. Although the *McNamara* test comes close to effectuating congressional intent because the court first accepts the written lease and then the Commissioner must prove the transaction is a "sham," the further requirement that each leasing transaction be examined for the appropriate retention of economic risk by the lessor goes beyond the scope of the statute. The difficulty lies in fashioning a test which allows the honest noncorporate lessor to take advantage of the ITC as Congress provided. The approach taken by the *Sauey* court best reflects the intent of Congress and strikes a workable balance between *Connor* and *McNamara*. In *Sauey*, the court directs that all non-corporate lessors are eligible for the ITC if the transaction satisfies the two-pronged test of the statute, but requires further evidence to show the lease is a legitimate business transaction.¹²² This means that in a case where a short-term lease, by business circumstance alone, becomes long-term, the taxpayer is given an opportunity to rebut the Commissioner's conclusory evidence that a long-term arrangement was intended from the inception of the lease.

The realistic contemplation test, even if used to prevent shelter of other income by commonly controlled entities, should be rejected as an overly broad application of the statute that reaches beyond the scope of the statute and its congressional history. The *Connor* court also posited that deference is due to the Commissioner's interpretation of the short-term lease test. As discussed in the following section, this

120. WEBSTER'S THIRD NEW INT'L DICTIONARY 491 (3d ed. 1976).

121. *Id.* at 1475.

122. *See supra* notes 107-09 and accompanying text.

rationale for sustaining the Commissioner's realistic contemplation test is unwarranted.

B. *The Deference Issue: Concepts and Cases*

This section explores the issue of deference to the Commissioner's interpretation of the short-term lease test by describing the rationale for deference to administrative agencies and by analyzing the pertinent case law on judicial deference to the Commissioner's interpretation of the Internal Revenue Code. The Commissioner's interpretation of the short-term lease test, calculated to disallow the ITC, has varied over time. Cases illustrating these varied interpretations are presented.

There are several criteria to which the courts look in determining the degree of deference to accord an agency interpretation of a statute. These include: the congressional intent as to the discretion to be afforded that agency; the superior knowledge or degree of expertise in the agency; and the limits on the court's power to effectuate policy decisions because those decisions are ultimately within the agency's jurisdiction.¹²³ The Commissioner has traditionally been afforded a great degree of deference from the judiciary because of the complexity of the Internal Revenue Code and the expertise and understanding of the code as a whole needed for proper interpretation of the various sections.¹²⁴

In *Bob Jones University v. United States*,¹²⁵ the United States Supreme Court recognized the broad power vested by Congress in the Commissioner to administer and interpret the tax laws.¹²⁶ The Court stated, "Ever since the inception of the Tax Code, Congress has seen fit to vest in those administering the tax laws very broad authority to interpret those laws. . . . [C]ongress expressly authorized the Commissioner 'to make all needful rules and regulations for the enforcement' of the tax laws."¹²⁷ Applying this principle, the Court in *Jewett v. Commissioner*¹²⁸ deferred to the Commissioner's viewpoint when the

123. R. PIERCE, JR., S. SHAPIRO & P. VERKUIL, *ADMINISTRATIVE LAW AND PROCESS*, § 7.1, at 351-52 (1985) [hereinafter R. PIERCE, JR.].

124. See, e.g., *Commissioner v. Engle*, 464 U.S. 206, 224 (1984); *Bob Jones University v. United States*, 461 U.S. 574, 596-97 (1983); *Jewett v. Commissioner*, 455 U.S. 305, 318 (1982).

125. 461 U.S. 574 (1983) (United States Supreme Court found Commissioner's denial of tax-exempt status to a private school, based on that school's practice of racial discrimination, to be a policy determination within the Commissioner's power).

126. *Id.* at 596-97.

127. *Id.* at 596.

128. 455 U.S. 305 (1982) (determination of the meaning of "transfer" as applied to testamentary transfers for federal gift tax purposes).

positions of both the taxpayer and the Commissioner found support in the code.

The purpose of judicial review of agency action is to confine such action within the boundaries or limits set by Congress in the pertinent legislation.¹²⁹ Thus, as a threshold, the agency's action must be consistent with the policies of the legislature for the courts to find in favor of the agency.¹³⁰ In addition to statutory interpretation that is consistent with the intent of Congress, consistency refers to agency uniformity in interpretation of a statute. By requiring consistent interpretations, the courts ensure that the public is provided notice as to permissible conduct concerning matters within the agency's jurisdiction. Thus, "[r]eviewing courts . . . search for (1) internal consistency and rationality in the agency's reasoning process; (2) interdecisional consistency . . . similar cases being resolved in a similar manner; and, (3) intertemporal consistency . . . the agency applying the same decisional standards over time."¹³¹ The rationality concept also focuses on the Commissioner's application of the statute and requires that the agency decision be nondiscriminatory. The agency must consider all relevant factors prior to making its decision and avoid "making its decisions in a discriminatory manner based on the personal . . . characteristics of the parties affected by the agency's action."¹³²

In *Jewett*, the Court afforded respect to the Commissioner's interpretation of the tax code because this interpretation was consistent over a fifty year period.¹³³ By contrast, in *Commissioner v. Engle*,¹³⁴ the Court refused to defer to the Commissioner's interpretation of the tax code.¹³⁵ While recognizing that the Commissioner is generally af-

129. R. PIERCE, JR., *supra* note 123, § 5.1.4, at 124.

130. *Id.* § 7.1, at 350 ("[a]n agency's action is consistent with the policy decisions of Congress only if the agency's action is based on an accurate determination of legislative intent and an accurate determination of the factual predicates for the agency's action"). *Id.*

131. *Id.* § 5.1.5, at 127.

132. *Id.* § 7.1, at 353.

133. *Jewett*, 455 U.S. at 311-12, 318. "Both positions find support in the language of the Regulation." *Id.* at 311. "Because that text is not entirely clear, however, it is appropriate to examine briefly the Regulation's history." *Id.* at 312. "The Commissioner's interpretation of the Regulation has been consistent over the years and is entitled to respect." *Id.* at 318.

134. 464 U.S. 206 (1984) (taxpayers challenged the Commissioner's interpretation which disallowed depletion allowances for oil and gas reserves).

135. In addition to arguing for deference, the Commissioner argued that his interpretation provided greater administrative convenience. The Court dismissed the Commissioner's administrative convenience argument stating, "[e]liminating the allowance [for depletion of gas and oil reserves] might make the statute 'simpler to administer,' . . . but it

forded a high degree of deference, the Court applied a standard of reasonableness to the Commissioner's interpretation. Using the standard of reasonableness as measured against the congressional history of the statute,¹³⁶ the Court found the Commissioner's interpretation unreasonable and inconsistent with congressional intent.

When interpreting the short-term lease test, the Commissioner invokes a variety of conflicting tests to disallow the ITC and alters his arguments according to the facts of the case. The Commissioner's history of inconsistent interpretation of the statute calls into question the propriety of judicial deference to the Commissioner's interpretations. Additionally, the Commissioner has suggested another test, the "trade or business" test,¹³⁷ which the Tax Court rejected.

*Stewart IV v. U.S.A.*¹³⁸ presented an issue analogous to the short-term lease test. To qualify for an ITC, the lessor was required to prove that its leases to a governmental body, the Post Office, were short-term.¹³⁹ The leases as written were short-term, but allowed for automatic renewal unless cancelled.¹⁴⁰ Taking an approach similar to that in the *Connor* case, the Commissioner argued that the actual length of the rental rather than the term of the lease should control.¹⁴¹ The taxpayer argued that the district court should enforce the six month legal minimum term of the lease, making it a short-term lease, because there was no assurance that the lease would extend beyond that period.¹⁴² The district court held for the Commissioner stating that "the controlling question is the duration of the actual use rather than the

does so by ignoring the language of the statute, the views of those who sought its enactment, and the purpose they articulated." *Id.* at 227.

136. *Id.* at 220, 224. "[T]he true meaning of a single section of a statute in a setting as complex as that of the revenue acts, however precise its language, cannot be ascertained if it be considered apart from related sections, or if the mind be isolated from the history of the income tax legislation of which it is an integral part." *Id.* at 223 (quoting *Helvering v. Morgan's, Inc.*, 293 U.S. 121, 126 (1934)).

137. *Miller v. Commissioner*, 85 T.C. 1064 (1985). See *infra* notes 148-52 and accompanying text.

138. 77-2 U.S. Tax Cas. (CCH) ¶ 9648 (D. Neb. 1977).

139. I.R.C. § 48(a)(5) (1954).

140. The terms of the lease were:

The term of all contracts extended from the date of delivery to the end of the fiscal year. The contracts were automatically renewable for up to three fiscal years unless sooner cancelled. Either party to the contract had the option to cancel the contract after six months by giving thirty days' written notice. During any renewal period following the end of the fiscal year in which the contract was negotiated, either party could cancel on one day's notice.

Stewart IV, 77-2 U.S. Tax Cas. (CCH) ¶ 9648 at 88,176.

141. *Id.* at 88,177.

142. *Id.* at 88,175-76.

term of any single lease, since the leases were subject to automatic renewal unless the parties took affirmative action.”¹⁴³

In *Hoisington v. Commissioner*,¹⁴⁴ the lessor partnership was created to purchase and lease to drivers refrigerated freight trucks then owned by a related corporation to encourage driver ownership of the vehicles. The lessees invoked early cancellation clauses in accordance with the terms of their long-term leases.¹⁴⁵ As a result, the actual duration of the leases was short-term. The taxpayers claimed that under these facts, their property should qualify for the ITC. In *Hoisington*, the Commissioner abandoned the realistic contemplation test advanced in *Connor*, instead arguing that the ITC should be disallowed on the basis of the terms stated within the written lease. The taxpayers argued that the substance of the transaction should be determinative of compliance with the short-term lease test.

On appeal, the Tenth Circuit Court of Appeals agreed with the Commissioner’s argument that the term fixed within the long-term lease should be determinative,¹⁴⁶ stating that “[s]ubstance over form is a doctrine which should be resorted to sparingly. It is not a wholesale license to dismantle and reform transactions by hindsight to achieve a certain tax result. In general, bona fide contracts ought to be respected.”¹⁴⁷

In *Miller v. Commissioner*,¹⁴⁸ to disallow the ITC, the Commis-

143. *Id.* at 88,177.

144. 833 F.2d 1398 (10th Cir. 1987). Graves Trucklines, Inc. (GTI) created a partnership, Power Leasing Associates (PLA), to effectuate the purchase and lease of refrigerated trucks to driver-employees of GTI. PLA was the lessor and the driver-employees were the lessees. The lessee and lessor were not commonly controlled; however, the degree to which this transaction was at arms-length is debatable. *Id.* at 1399-1402.

145. The leases allowed early cancellation so that drivers, not opting to own their vehicles after a trial period, could retain their status as members of the Teamsters Union. *Id.* at 1401. “Cancellation of the leases was permitted on thirty days notice, and fourteen of the leases cancelled within . . . [the strictures of the short-term lease test].” *Id.* at 1399.

146. *Id.* at 1405-06. “[N]o court has yet held that the . . . [reasonable contemplation] test is appropriate for reducing the fixed term of a lease. . . . [W]e reject the argument that the taxpayers’ reasonable contemplation of early cancellation overrides the actual agreement as to the fixed lease term. Just as in substance versus form, the written agreement of the parties also expresses their contemplation with respect to the lease. . . .” *Id.* at 1406.

147. *Id.* at 1405. The court elaborated stating:

Further, the doctrine is not the exclusive province of the government. However, the problem with the taxpayers’ invocation of substance over form is that they are faced with the dilemma of repudiating their own transaction expressed in terms of their own choosing. Especially in circumstances where the agreement is adverse to the interest of the drafter, the original written version *is* the substance, and the drafter is essentially estopped from denying that point.

Id.

148. 85 T.C. 1064 (1985) (partnership obtained recourse financing from an unrelated

sioner proposed that, in addition to the two-pronged test of Section 46(e)(3)(B),¹⁴⁹ which included the short-term lease test, the Tax Court should apply a trade or business test. That test required that "the noncorporate lessor independently . . . establish that he was engaged in the trade or business of leasing and that the particular lease in question was a part of that trade or business."¹⁵⁰ The Commissioner argued that this test would ensure compliance with the specific legislative intent of the short-term lease test because the ITC would be denied where leasing transactions were used as devices to shelter other income from tax.¹⁵¹ The Tax Court held against the Commissioner, allowed the ITC, and held that the statute required and Congress intended only compliance with the two-pronged test.¹⁵²

Thus, the Commissioner has invoked a variety of interpretations of the short-term lease test to disallow the ITC. As stated in *Hoisington*,¹⁵³ "the government has been on all sides of the issue [of which test applies], depending on the advantage to be gained."¹⁵⁴ This lack of uniformity in interpreting the code supports the *McNamara* court's decision not to defer to the Commissioner. The *Connor* court improperly deferred to the Commissioner because deference to an administrative agency's interpretation is not warranted when that interpretation has not been uniform over time.¹⁵⁵

The *Connor* decision fails first because acceptance of the Commissioner's realistic contemplation test contravenes the intent of Congress. Second, the decision fails because judicial deference to the Commissioner's interpretation is improper. The *McNamara* test more closely parallels congressional intent because the court initially accepts the written lease. But then *McNamara* goes too far and applies its

party to purchase Section 38 property, a crane costing \$451,225.00, for lease to its related corporation. Use of the ITC generated deficiencies of \$90,496.00). *Id.* at 1065-66. See *contra* *Niagara County Sav. Bank v. Commissioner*, 48 T.C.M. (CCH) 51 (1984) (ITC denied where lease of Section 38 property by partnership to related corporation found to be a financing device only. The Tax Court found that there was no good faith business purpose for the lease and no evidence that the partnership performed business functions other than holding title.).

149. See *supra* note 29 and accompanying text.

150. *Miller*, 85 T.C. at 1070.

151. *Id.*

152. *Id.* at 1073-75. The Tax Court also held that even if the Commissioner's argument for a trade or business test was valid, this partnership was in the business of leasing and not merely established as a financing device. *Id.*

153. 833 F.2d 1398 (10th Cir. 1987). See *supra* notes 144-47 and accompanying text.

154. *Id.* at 1406.

155. R. PIERCE, JR., *supra* note 123, § 5.1.5, at 127. See *supra* note 117 and accompanying text.

own subjective standard, an evaluation of risk retained by the lessor, that is beyond congressional intent. The *Sauey* decision¹⁵⁶ returns the court to the basic purpose of the statute and enforces within reasonable bounds the ability of the commonly controlled non-corporate lessor to take an ITC. Based upon principles of statutory analysis, congressional intent, and judicial deference, the *Sauey* decision is correct.

IV. CONCLUSION

The result of the foregoing is uncertainty for the taxpayer in his business and tax planning and for the Commissioner in determining when the ITC should be disallowed. Congress provided that the ITC be used for actual investment in business property and so made it available to non-corporate lessors under very particular circumstances including the strictures of the short-term lease test. The short-term lease test supplies a clearly defined standard: the lease must be less than half the useful life of the property. Despite this, the courts have struggled to reconcile the written lease, the substance of the transaction, and a suspicion of the business practices of commonly controlled entities. The court's approach to setting a standard has been fraught with confusion. A court applying the Commissioner's realistic contemplation test to a short-term lease which has been continuously renewed will judge the lease to be of indefinite duration at conception. The test does not address the possibility that the parties actually intended to create a short-term lease.

Additionally, in light of the variety of approaches taken by the Commissioner, the fairness and legitimacy of a court deferring to the Commissioner's interpretation of the short-term lease test is questionable. The Commissioner's tests are tailored to disallow the ITC rather than to interpret the statute fairly. The Commissioner has exceeded his limits of discretion. A taxpayer should not be forced into litigation simply because of the Commissioner's suspicion of common control when Congress has not forbidden the benefits of the ITC to such parties. Simple adherence to the statutory scheme would allow the taxpayer the requisite certainty in his business and tax planning.

Gail M. Corbett

156. See *supra* notes 105-15 and accompanying text.